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General Business Conditions

THE state of sentiment at the year-end suggests that business men are looking into 1947 with awareness of its problems, but with good spirit and enterprise, and on the whole with less fear of a precipitous decline in trade and production than they felt earlier in the Fall. The break in the stock market last September was a violent and spectacular affair. It turned some people into outright pessimists and induced in others feelings of confusion and nervous apprehension. It started a flood of inquiry as to whether a repetition of the 1920 break in prices and business activity was in the making.

In three months, however, a considerable exchange of information and clarification of ideas occurs. There has been time to weigh the strong and weak points in the outlook, to see what adjustments are needed, and to gain a better perspective. The effect has been to allay the more extreme anxieties. Business men who have given the situation this kind of study appreciate the weight of the factors which tend to sustain and prolong high activity. They do not under-estimate the possibility of recession and price decline, but neither do they go into the year in a state of fear or fatalistic expectation of depression.

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A Preview of 1947 Problems

The closing weeks of 1946 have given a preview of some of the problems that 1947 will present. They have also provided evidence that business men are attacking these problems as they show themselves. As the year goes on this foresight should prove of great benefit. It suggests that readjustments will be piecemeal and spread out instead of deferred and bunched together at some future time, in which case they would be immensely more disturbing.

One area where a problem is seen and readjustment is generally under way is in retailing. From the beginning of the war sellers' markets in consumers' goods have prevailed. During much of this time producers were hampered by materials shortages, rising costs and price controls. In many cases low-priced lines almost disappeared from the market, and inferior or over-finished goods and high-priced novelties were turned out at the expense of staples. Even so, sales did not suffer. Consumers had purchasing power and when the choice was to take or do without they bought what was offered.

Retailers and producers of consumers' goods now agree that this era has ended. The visible evidence is in price declines in furs, diamonds, jewelry and some food products; in retail mark-downs, especially on women's apparel, even during Christmas; and in the reappearance of post-Christmas sales. The overall problem now is to adjust production again to meet consumer preferences; to provide as in the past lines for every pocketbook; to clear out of stocks the excess and sub-standard merchandise; and to square away to do a normal competitive business, in which the consumer is umpire with no appeal from his decisions.

Retailers have not waited until demand subsided to prepare for these changed conditions. Their common policy is to reduce inventories and shorten commitments. They are carrying out this policy while demand is still supported by high purchasing power, and they propose to have the situation in order if a falling off in employment and payrolls should come and deal a real blow to their sales.

Manufacturers' inventories are a subject of comment along with those of retailers, and were referred to in this Letter last month. They are not excessive when measured against sales and shipments, but on the contrary are short, according to relationships which have prevailed in the past. While speculation for higher prices undoubtedly has animated some buying, the primary reason for building up stocks has been to support the expansion of sales, and there has been a notable increase of caution in recent weeks. Nevertheless, inventories are unbalanced, and as in the past they would become excessive in some things if sales should fall off.

Forecasters expecting a business decline put stress on inventory accumulation, but not primarily because they fear liquidation will suddenly set in and cause depression. Their main argument is that inventory buying has swollen the demand in the markets, and that when it ceases there will be a smaller outlet for production unless other demands rise to a compensating extent. This is true, but it is not the last word on the matter. For if prices and incomes are in balance and the pattern of production fits the demands of the buyers, there is never any reason why buying cannot absorb full production. This puts the emphasis on other aspects of the outlook, namely, the balance in costs, prices and income relationships.

A Shift in Demand and Production

A problem of the economy as a whole in the coming year is to make the changes required as the proportion of non-durable goods bought by consumers declines while the proportion of durable goods rises. This shift is already under way, but has had no business effect because there has been room for expansion in both kinds of goods. However, the catching up with deferred needs goes faster in non-durables than in durables, and as the year goes on the pattern of consumer expenditure may be expected to shift toward the latter.

Shifts in demand require shifts in production, and the question is whether overall activity can be sustained if there is some easing in production and employment in non-durables. The problem is to take up the slack by expansion in construction, automobiles, and other hard goods. Such transitions are not easy. On the other hand, demands on the durable goods industries are so intense, and plans for expansion so widespread, that it is hard to believe the transition problem can have more than secondary importance. All economic precedents are against a major depression originating in the soft goods industries, for by their nature their cycle of decline and recovery is a short one. When durable goods production is making a full contribution to income and purchasing power, adjustments in non-durables make only a minor impression on the general situation.

Food Prices and Living Costs

Another preview of an adjustment that is likely to go further in 1947 has been given in certain food markets. It is now generally agreed that the peak in farm and food prices has been seen, and that further declines are to be expected, possibly even before the approach of the 1947 harvests. At several press conferences during the past month Secretary of Agriculture Anderson has expressed belief that retail food prices will level off for several months and then decline later this year. The Bureau of Agricultural Economics has predicted a 5 to 10 per cent decline in farm prices from the October peaks over the next few months, and a 15 to 20 per cent decline for the marketing year beginning July 1st next.

The peak in meat and lard prices clearly was passed several weeks ago, for the drop in these commodities from the high points reached after decontrol has been of the order of 34 per cent in wholesale beef, 43 per cent in pork shoulders, and 55 per cent in lard. Lesser declines have occurred in butter and eggs, corn, wheat, and flour. Contracts for distant future delivery in almost all agricultural products are below current spot prices. Citrus fruits and canned juices have had a violent decline, and weakness in some other canned and frozen foods is observed.

The high cost of living is one of the major economic problems of 1947. The trend of the relationship between incomes and living costs for some time past has been unfavorable. Per capita national income after taxes almost doubled during the war, while the cost of living, according to the Bureau of Labor Statistics consumer price index, increased only 30 per cent. Since the end of the war, however, the increase in disposable income per capita has been less than 6 per cent, while the cost of living, using the figure for November 15, increased 17.2 per cent. Most of the jump has occurred in the past five months. This is moving in the wrong direction. If the cost of living can be cut without an equivalent decline in national income — which is possible by increasing productivity — real purchasing power will rise, and nothing could so improve the outlook.

One way to narrow the gap, and one which it is now seen free markets will accomplish, is to bring down the retail food prices which are so weighty in the cost of living, and which have risen as compared with prewar more than other prices and the run of wage rates. Declines in prices of farm products may mean moderately smaller incomes for farmers, even though production is huge as now expected. Nevertheless, the net effect of lower food prices upon the economy should be beneficial. Farmers as a group are in unprecedentedly good financial shape, with reduced debt and increased liquid assets. They have had a greater rise in income and buying power than most other elements of the population. Any general survey would conclude that they can stand a modest loss of income through price declines better than the rest of the people can stand a continuation of present living costs. As buyers they will benefit along with city people from a check to the upward trend, and the obvious place for the check to begin was in foods.

From that standpoint it would be wrong to consider the prospective drop in food prices as bearish on the general situation. Rather it helps restore balance and stability, maintain real purchasing power, and support trade.

Lower Unit Costs Needed

The second way to bring down living costs relative to income is to improve the efficiency of industrial output, reduce unit costs of industrial products, and pass the saving along in lower prices in which everyone can share. To bring this about is the most urgent problem of management and labor in 1947, and the extent to which it may or may not be accomplished is the year's greatest enigma.

Union leaders have a different approach to the income-price relationship. They favor increases in money wages. However, this is an illusory route. We shall not anticipate here the discussion of the CIO proposals which appears further on in this Letter, except to point out that general and substantial wage increases cannot possibly be absorbed without increasing prices, because they could not be so absorbed by *all* producers. Even if statistically correct, calculations as to what wage increase employers *on the average* can absorb are meaningless, for there is no pooling of enterprise, profits and losses in this country, and changes in costs exert their influence not on the average but on the margin. Hence the proposal to catch up with the cost of living by raising wages is one which would give another turn to the wage-price spiral.

As was said here a month ago, "the longer the wage-price spiral lasts and the higher it ascends the greater is the danger that the next turn will destroy the balance of the structure and start it toppling." Organized labor includes only about one-fourth of the gainfully employed people in the country. If one group insists on higher money wages which lead to higher prices than other groups, in the long run, can pay, the product is priced out of the market and the nominal money gains of the workers are given up in unemployment.

As opposed to this illusory means of catching up may be set the advantages of effort to increase efficiency and production, and of waiting, in the interest of stability, until normal competitive forces and the return of buyers' markets in one line after another bring down living costs. When productive efficiency is increased, and the benefits are distributed through lower prices, all groups go forward together.

Any forecast that 1947 will be a good year must be based, in final analysis, upon a belief that through good sense and mutual adjustment a workable answer will be found to the wage question. For if the year is to be one of long and costly strikes, or if an exorbitant price, in the form of wage increases which the economy cannot possibly sustain, is to be paid to avoid strikes, then depression threatens.

The Supporting Influences

Our discussion thus far has covered the possibility of recession in non-durable goods later in 1947; it has noted the problems of price adjustment and alignment of production and inventory to market changes; it has referred to the depressing effects of the rise in living costs and to the hopeful indications of lower food prices; and it has stressed that needed readjustments have already started and promise to be spread out instead of having their impact all at one time. We also said at the outset that business men who have studied the economic situation appreciate the weight of the factors which tend to sustain and prolong high activity, and in conclusion we turn to these factors. They are to be found in the need for goods here and over the world, in a widespread policy of expansion and improvement in the industries, and in the strength of monetary and financial influences.

Few would deny that if activity in durable goods holds up no general depression need be feared. If a poll in the durable goods industries were taken today it would show that needs for most of their products are still enormous. Inquiry among manufacturers of capital goods would show that most of them are sold well ahead, and are worried more about production and deliveries than about sales. Labor criticizes business profits as if profits were never spent and therefore created no production or employment, but the expansion plans which are being carried out in all industries

and by a great majority of individual companies give an answer.

The construction outlook has been improved by President Truman's action in liberalizing building restrictions. Most estimates of construction activity in 1947 are optimistic, projecting a good increase over 1946, and they are well-grounded on increased production of materials. A more even flow of materials to the construction scene will help immensely in reducing exorbitant construction costs, for costs are increased not only by waiting and delay, but because building labor tends to stretch out work, in order to avoid layoffs, when materials are short. In consumers' durable goods the markets are equally strong. Fears have been expressed that automobiles have been priced out of the market, but the fact that very large premiums over list prices are obtainable on new cars offered for re-sale shows that this fear is premature.

Another important supporting factor is the virtual certainty that 1947 will be another year of a large export surplus. The unsatisfied demand abroad for American manufactured goods is a matter of common observation. It will give support against any contraction of domestic buying, and in some of the soft goods industries particularly this support may be valuable.

Monetary and Financial Factors

One reason why booms come to an end is that the ability to finance further expansion either in volume or prices runs out. Business men may run out of money, and banks out of reserves upon which they could expand credit. This happened in 1920 and is part of the explanation of the 1920-21 depression.

Now, however, monetary and financial influences are of a kind to support and prolong the boom. The money supply, consisting of currency outside the banks and deposits against which people can write checks, currently is estimated at $108 billions, and has more than tripled since the beginning of the war. It is circulating slowly by all past comparisons, and it could support more trade and production and still higher prices if people should decide to turn it over faster. It can be expanded further by making more bank loans, if deserving borrowers come forward, for there is no strain on bank reserves and little possibility that the central banking authorities will rigorously restrict credit.

Moreover, the money supply is backed by an unparalleled volume of liquid assets readily convertible into money. The total liquid assets held by the people of the country, including along with their cash and bank deposits war savings bonds and other government securities, were $222.5 billions on June 30, 1946, according to estimates of the Federal Reserve Board, against $65 billions at the end of 1939.

The increase in the money supply is the fundamental cause of the rise in the price level. It is almost impossible that the money supply can shrink by any substantial extent in any short period, for the increase in bank deposits has come about chiefly through government borrowing from the banks and to that extent can be retraced only by repaying the borrowings. Bank loans based on securities are but a fragment of what they have been at previous business peaks; no drain of current purchasing power to pay them off need be feared. Commercial loans have expanded sharply. They have been made for productive purposes, and in the main can be expected to shrink only if prices decline and inventories are liquidated; in other words, they will follow non-monetary influences. In any case, shrinkage of commercial loans could cut but little into the total money supply. Consumer credit is likely to expand further because it will be needed to finance purchases of automobiles and other durable goods during the coming year.

The Price Level

These factors — the financial liquidity of the economy as a whole and of most of its separate parts, the size of the money supply and the fact that it is subject to so little shrinkage — should give assurance against general or major liquidation. They give strong reason for believing that what is needed in the way of price adjustment is a correction of distortions, a realignment of prices among themselves and in relation to income, rather than a widespread retracement of the inflationary rise. Doubtless the effect of realignments will be to lower the general level, simply because prices have run ahead so fast and because some are too high to equate supply and demand in the year ahead, but adjustments will improve the outlook for trade and production.

Rightly seen, many of the economic difficulties of recent years derive from the change from one price level to another and higher one. They are attributable to the fact that not all prices and incomes move up together and in balance. The current problem is to work out a sustained balance on a new level. The task is difficult, and the degree of cooperation, self-discipline and devotion to the general welfare that people bring to it will greatly influence the course of business through 1947. Declines in prices that are too high will contribute to a new balance by restoring the purchasing power of people whose incomes have lagged. The most unfavorable development would be an increase in industrial costs and prices, which would again leave large population groups striving to catch up.

An Official Forecast

On December 18 President Truman made public the first report of the Council of Economic Advisers, established by the so-called "Full Employment Act" of 1946. Included in its discussion of long-range economic problems is a statement of the outlook which, although specific prophecy is avoided, may be considered an official forecast for 1947. The report expresses the view that outlook for production and jobs —

> should be more than ordinarily favorable for the period of some years ahead. In spite of certain conditions that might make a dip in 1947, we believe that courageous and sensible action by those responsible for the administration of private business relations (including labor unions) can at least hold such a recession to moderate proportions if not avert it . . .
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> We do not find many accredited business officials or professional economists who are really apprehensive that a recession once started will induce a downward spiral into deep or prolonged depression, although a chain reaction in the economic area is always conceivable. The basic economic conditions show such a strong recuperative power as to minimize such a fear — barring international tension verging on war or a persistent round of strikes.

In another section the report speaks of "mutual adjustment of wage, price, cost and profit relations by the voluntary bargaining of the parties at interest." It adds:

> We believe that the outlook for production and jobs in 1947 lies primarily in whether the responsible persons in these groups will show a willingness to face the issues and demands of a free enterprise system realistically . . .

This statement, without indicating the precise nature of the adjustments needed, defines the area of concern. The Council then goes on to make another statement which should gratify every believer in free enterprise and everyone who is sensible that the inflationary menace is still latent:

> Mere legislative acts alone will not force capitalists to invest, employers to hire, or laborers to work. What was said in the previous section also indicates that we do not believe that 1947 presents a situation in which government should undertake heroic measures of public works, consumer or producer subsidies to quicken employment or stimulate production. We suggest that the impediments to prosperity in the near future are of the sort that must be worked out, without benefit of direct government intervention, through the practical wisdom of management and labor, farmers, and financiers.

The Nathan Report on Wage Policy

The report on "A National Wage Policy for 1947" by the Robert R. Nathan Associates, Inc., of Washington, D. C., prepared for the Congress of Industrial Organizations and made public last month, has rapidly become one of the most talked about and hotly debated documents that has appeared in a long time. Advancing, as it does, the thesis that substantial wage increases are essential to sustain purchasing power of the workers and avert economic collapse, and that such increases can be granted out of the high profits of business without increasing prices, the report has been recognized as a key element in the strategy of the CIO's recently announced drive for a new round of wage increases.

It will be recalled that the CIO, even before publication of the Nathan study, had taken the position officially that profits were excessive and a menace to economic stability, and that business could well afford to grant large wage increases without raising prices. President Murray of the CIO and other speakers before the annual convention at Atlantic City in November referred repeatedly to "staggering" corporate profits and predicted dire consequences to the country if they were allowed to continue. At the same time, the November issue of the CIO monthly bulletin, "Economic Outlook," cited an extensive array of facts and figures purporting to sustain this position. These were the subject of comment in our Letter a month ago.

In pushing this program, the CIO has had to contend with public memory of what happened last Winter when the movement for wage increases received powerful stimulus from the "leak" of a government report, the authorship of which has never been made entirely clear, to the effect that industry generally could advance wages 24 per cent without price increases. Actually, of course, the results were quite different. Not only were wage increases followed by price increases which the OPA was forced to approve to keep production going, but the resultant bulge in the price control lines started the final weakening that ultimately broke the control system altogether.

The CIO, evidently recognizing that its case with the public would be stronger if supported by independent evidence, engaged the services of the Nathan Associates, headed by Robert R. Nathan, former Deputy Administrator of the Office of War Mobilization and Reconversion, to make a survey and report on wage policy. While the impartiality of the report has been questioned by many, nevertheless labor and the general public expect and are entitled to an answer on the merits of the facts and conclusions as presented.

The Nathan Thesis

What, then, are the principal claims of the Nathan report? Briefly, they may be summarized as follows:

1. That since 1944 there has been a decline in the real value of earnings of wage and salary workers, due both to lower dollar earnings (reduction of overtime pay, shifts to lower paid occupations, etc.) and to the sharp rise of prices. Meantime, corporate profits

after taxes have risen about 50 per cent and incomes of farmers (after expenses) about 40 per cent.

2. That this shift in the proportion of real income going to wage and salary workers and that going to profits involves three dangers —

(a) the living standards of the masses are being undermined,

(b) the long-term stability of the economy is being endangered by a "shift of income away from the consumption of the masses and toward the savings of the relatively few",

(c) the social and political health of our democracy is being threatened by the concentration of income, wealth, and power.

3. That correction of these "dangerous" trends cannot be expected through reductions in prices and profits save as a result of business depression and unemployment. Nor is it likely to be brought about by tax policy.

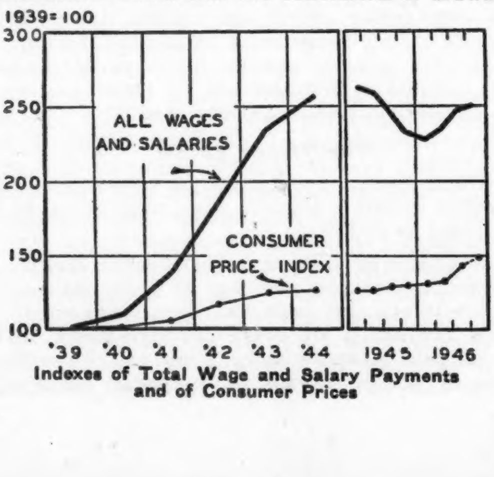
4. That the answer, therefore, must be to increase wages without increasing prices.

This last, the report concludes, can be done readily out of the "excess profits" business is making. Manufacturing corporations, it contends, could raise total earnings of production workers 21 per cent at the present time without raising prices or reducing the corporate return on net worth (shareholders' equity, represented by capital and surplus) below that of 1936-39, but leaving actual dollar net income about twice that of 1936-39. For all corporations, the report declares, the "excess profits" will support a general wage increase of "at least 25 per cent."

The Argument Examined

How sound is this analysis, and what of the remedy proposed? Let us take up the points in order.

Point No. 1. It is true that since 1944 there has been a decline in the aggregate purchasing power of all wages and salaries, while corporate earnings and farm income have increased. From this the conclusion is drawn



Indexes of Total Wage and Salary Payments and of Consumer Prices

(*Point 2-a*) that the living standards of the masses are being undermined.

The extent to which living standards are "undermined" is illustrated by the accompanying chart, based upon figures taken from the appendix of the report itself, comparing since 1939 the total wage and salary payments with the Bureau of Labor index of consumer prices.

It will be seen that in the fourth quarter 1946, aggregate wage and salary payments were running at a rate only 2 per cent below the 1944 average, and only 5 per cent below the first quarter 1945 wartime peak. At that time, the national economy was operating at forced draft and total wage disbursements were swelled not only by overtime payments and widespread shifts of workers to higher-paying jobs, but also by expansion of the total labor force through employment of housewives, over-age persons, etc. As compared with prewar 1939, total wage and salary payments in the fourth quarter 1946 were up 150 per cent.

On the other hand, the consumer price index, while 18 per cent higher in October 1946 than in 1944, was but 49 per cent above the 1939 average, an increase of about one third that of total wage and salary payments.

In other words, the "living standards of the masses" as measured by the purchasing power of wages and salaries are now well above the prewar level and, except for the temporary wartime peak, the highest in the history of the country.

The improvement in real income of regularly employed persons shows up strikingly even when comparison is made on the basis of average weekly earnings of factory workers, instead of total wages and salaries which reflect the wartime expansion of the labor force. In the Nathan report a comparison is given of the change in average weekly earnings of six selected industries between January 1945 and October 1946. How the comparison would look if made with prewar levels, and after allowance for price changes, is shown in the next table for these lines and also for all manufacturing and for coal mining.

Changes in Actual and Real* Average Weekly Wage Earnings

		Oct. 1946		% Change from 1939	
Industries	1939	Actual	Real*	Actual	Real*
Automobiles	$32.91	$53.12	$35.58	+ 61.4	+ 8.1
Steel	29.88	50.28	33.68	+ 68.4	+12.7
Petrol. & Coal Prod. Mfg.	32.62	55.20	36.97	+ 69.2	+13.3
Lumber & Timber Prods.	19.06	38.79	25.98	+103.5	+36.3
Canning & Preserving	16.77	41.54	27.82	+147.7	+65.9
Gen. Retail Mdse. Stores	17.80	28.57	19.14	+ 60.5	+ 7.5
All Manufacturing	23.86	45.83	30.70	+ 92.1	+28.7
Bit. Coal Mining	23.88	61.00	40.86	+155.4	+71.1

*Actual weekly dollar earnings adjusted to change in cost of living index, to show change in real earnings in terms of purchasing power.

The evidence given here of the improvement in the purchasing power of wage earners over the war period is substantiated by the record-breaking level of consumer expenditures for the year 1946 as reported by the Department of Commerce, with the monthly figures through October showing no let-down and Christmas trade reported at a new high.

Point 2-b, contending that a rise in profits relative to wages means that "the long term stability of the economy is being endangered by a shift of income away from the consumption of the masses and toward the savings of a relatively few" represents an old bogey that is continually cropping up.

It implies, first, that money distributed as wages and salaries is spent currently and thus supports general economic activity, but that business net earnings are largely "saved" and withheld from use and hence create a lag in the flow of income payments through the economy.

While this may be true in periods of business depression when confidence and incentive for investment are lacking, it is certainly not true at the present time. Business is in the midst of a great program of reconversion, modernization and expansion, and is not only spending its past and current earnings not paid out in dividends but is borrowing from banks and raising large amounts of new capital through flotations of stocks and bonds.

Secondly, this bogey exaggerates the proportion that profits bear to the national income. Even on the basis of Mr. Nathan's liberal estimates, the 1946 net income of all corporations (including both dividends paid and retained income) would be only 7.4 per cent of total national income.

But one of the most unsatisfactory parts of the Nathan report, as pointed out by Professor Sumner H. Slichter of Harvard University in an article in the New York Herald-Tribune of December 20, is its failure to understand the role of profits in the modern economy. Professor Slichter says:

> **Profits are the reward for two peculiarly useful activities. They are the return which business owners receive on equity capital and they are the yardstick by which managers demonstrate their efficiency to their employers by developing new methods and new products. Hence, the opportunity to make a profit is an incentive for investors to put more equity capital into industry and for managements to make more innovations.**
>
> **The striving of the owner operators and the managers of more than ten million business enterprises, agricultural and non-agricultural, to make more profit is what makes the American economy the most progressive and dynamic in the world.**

The charge, *Point 2-c* in the Nathan report, that increased profits are threatening the "social and political health of our democracy" through concentration of income and wealth and the "resultant concentration of power and influence" has a hollow ring indeed in view of the demonstrated power of the labor organizations to tie up the economic activities of the country almost at will.

Point No. 3 — that maladjustments in cost-price relationships cannot be corrected by declines in prices and profits without a depression—is illustrated by the following quotation from the report:

> **It is obviously futile, at the present time, to anticipate correction of these dangerous trends through reductions in prices and profits. The regulatory mechanisms by means of which reductions in prices and profits might have been achived, through government action, have been shattered irretrievably. Moreover, businessmen show no signs of exercising such self-restraint in their natural search for profits as would bring about a decline in prices except in the face of a sharp reduction in demand.**
>
> **On the contrary, the business community has first pushed aside price controls and then raised prices rapidly in the face of already huge profits.**

This statement is incorrect both in its assertion that the business community was responsible for the abolition of price control, and in its assertion that it is "obviously futile" to anticipate correction of present trends through reduction in prices and profits.

So far as the wartime price controls administered by OPA are concerned, the fact is that the business community, like many other groups, was of divided opinion as to continuing OPA up to the time of its temporary expiration on June 30. It was after the experience of what free markets would do in unblocking the flow of "scarce" commodities that the sentiment of the country, including business. turned overwhelmingly against the price control system. It will be recalled, moreover, that the most dramatic break in the price ceilings occurred in meats, and was caused by the unwillingness of hundreds of thousands of farmers and ranchers to market their livestock at prices which they regarded as unremunerative.

In short, it was the American people who rebelled against the whole scheme of price control, with its army of 55,000 paid government employes, red tape, black markets, and shortages. Senator Tom Connally, Democrat of Texas, came far closer than did Mr. Nathan in putting his finger on the essence of what happened when, in commenting on the November elections, he said, "We just got OPA'd out of existence."

As regards the "obvious futility" of expecting the correction of maladjustments through declines in prices and profits, the answer is that this is taking place daily before our eyes. Prices of many basic commodities and goods at wholesale have already topped off their rise and fallen sharply. Retail markdowns have been substantial and widespread, embracing not only high-priced luxury lines, but foods,

staple clothing, and a large variety of general merchandise. While the machinery of government price control may be, as the Nathan report says, "shattered irretrievably", it is being replaced by the far more effective force of increasing production and keener competition for the consumer's dollar. This force gives every promise of continuing to work in favor of the consumer unless stymied by extravagant wage demands that would raise costs and tend to freeze prices at the higher levels.

On "Taking it Out of Profits"

The first and most obvious objection to the proposal that the corporations can and should grant wage increases aggregating 21 to 25 per cent without increasing prices is the fallacy of taking gross overall profit figures as a measure of what individual industries and concerns can do.

Business, of course, does not operate as a single unit with all resources pooled, but is made up of many thousands of independent, competitive enterprises. Not only is there a great variety in the profit position in the different industries, but there is also wide variation among individual companies in the same industry. As pointed out in these columns a month ago, Treasury figures show that the proportion of all active corporations operating at a profit in any year has ranged from a low of 18 per cent in 1932 to a high of 67 per cent in 1943, and over the 28-year period 1916-43 for which official statistics are available has averaged only 50 per cent.

So long as these disparities in earning power exist, it is fantastic to talk about the ability of "industry" to grant big wage increases as though the money all came out of one cash register. Either prices would have to advance to enable a reasonable proportion of the "marginal" concerns to make a profit or the result would be a stifling of production and a falling off of employment. This was demonstrated, as indicated at the beginning of this article, by what happened to wages and prices last Winter.

While the Nathan report points out that its calculations are on an overall basis and not necessarily applicable to every company, the emphasis nevertheless is all on the global figures which are repeated over and over again and tend to become fixed in the public mind without qualifications. There is good reason to question whether the rank and file of the labor organizations, having been fed on a diet of such large figures and charges by some labor leaders of "staggering" profits and the "greedy desire" of "Big Business", will be in a mood to make fine distinctions. All this has the regrettable effect of encouraging distorted ideas, putting the more cautious labor leaders "on the spot", and making it harder for management and workers to get together on a reasonable and realistic basis.

A second objection to the proposed general wage increases without price increases arises from the narrow and uncertain base upon which corporate ability to absorb wage increases is calculated. What the Nathan report does is to take, not an estimate of corporate earnings for the full year 1946, but an estimate for the fourth quarter alone for which actual figures will not be available for some months Certainly, this as a very tenuous basis for the radical wage steps the report proposes.

For one thing, there is no attempt in the report to distinguish between operating earnings and earnings due to the rise in inventory valuation and carryback tax credits. Profits that have been swelled by inventory appreciation and that are represented by high-priced inventories on hand can melt away mighty quickly, as has been shown in some cases recently. Likewise the sharp improvement in 1946 operating margins, particularly in consumers' goods lines unimpeded by strikes, must b regarded as a temporary phenomenon associated with tremendous accumulation of demand and record volume of sales. This condition may be expected to adjust itself naturally with the passing of the temporary sellers' markets and reappearance of active competition.

Nathan 1936-39 Profits Standard Too Low

Still a third objection to the Nathan thesis is that, in determining whether current earnings are reasonable or excessive, the report goes back to the period 1936-39 as a standard from which to measure. After stating that the return on net worth of all corporations rose from a 1936-39 average of 2.9 per cent to 9.1 per cent in the fourth quarter of 1946, the report goes on to assert that "If all corporations were content to accept their 1936-39 rate of return on net worth, they could afford at the present time to grant wage increases of an annual value of about $17 billion"; manufacturing corporations could grant $5.1 billion.

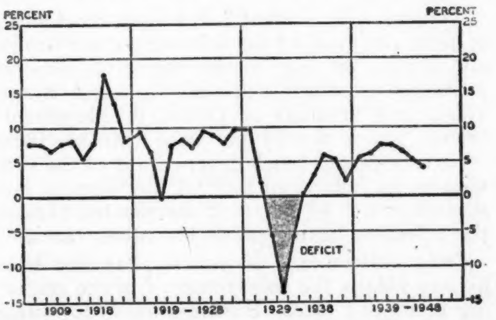
The question is, why *should* the corporations "be content" with their 1936-39 rate of return on shareholders' equity in the business? We venture the opinion that the average person would be amazed to learn how low (2.9 per cent for all corporations) the rate was.

The fact is that this earnings rate, which the Nathan report suggests that the corporations "be content" with, was that of a subnormal and semi-depressed period. For 1936-39 the rate of return on net worth was little more than half that of the late 1920s, even after allowance for the substantial depletion in net worth resulting from low earnings or deficits and asset write-downs in the early 1930s. It

was a time when the corporations not only had no net savings but paid out accumulated savings, and when the profit rate was not high enough to attract capital from the outside for corporate growth and expansion. Official recognition of the inadequacy of those years as a normal earnings standard appeared in the action of Congress in 1942 in changing the base for computation of the wartime excess profits taxes from the 1936-39 average to a formula amounting to substantially the average of the three *best* years of that period.

Moreover, the rise in costs of construction and of all materials and supplies since 1939 means that present reproduction costs of industrial plant and equipment generally are far above the original costs, less depreciation, at which they are being carried on the books and reflected in net worth. Business enterprises, like individuals, are finding that the cost of any new building or modernization is much higher than earlier estimates, and many corporations are having to raise substantial additions to their capital funds. At the same time, the shareholders who are being asked to put up more money have seen the purchasing power of their dividend dollars drastically cut.

Finally, in talking about profits, it is necessary to relate them to the general increase in practically all incomes brought about by the war. Both the Nathan report and some statements by labor leaders have given an impression of profits not only unprecedented, but expanded out of all proportion in the economy. Actually, while earnings in many lines are high, they are in the aggregate not out of line when measured against the rise of the national income as a whole. Thus, even on the basis of the Nathan estimates, the net income of all corporations represents for the full year 1946 only 7.4 per cent of total national income, and for the fourth quarter about 8 per cent. These, as the accompanying long-term chart shows, would be well below the rate in previous periods of high economic activity and compare with a 37-year 1909-45 average of 5.7 per cent.



Annual Percentage of Net Income of All Active Corporations in the U. S. to Total National Income 1909-1945

The Real Test

But while all these statistical comparisons have their bearing upon the question as to whether profits are too high or too low, they fail to go to the heart of the matter. The real test is not how current earnings compare with some particular period in the past, but whether they are "right" to perform their function in the economy. On this point the comments by Professor Slichter in the article cited above are so pertinent that, in concluding this discussion, we quote further from him as follows:

Mr. Nathan's repeated assertions that "profits are too large" raises the question of what yardstick one should use in judging what volume of profits is right. In some industries, as I have pointed out, profits are "too large" because of temporary bulges in demand or impediments to production which have raised profits above the levels needed to attract into these industries the amount of capital which is justified by the normal demand for the products of the industries. For industry as a whole, however, what determines whether or not profits are "too large"? Obviously this depends upon the rate at which the community wishes the plant and equipment of industry to be expanded.

The higher the rate of profit, the greater the proportion of the country's productive capacity which will be devoted to increasing the plant and equipment of industry. The lower the rate of profit, the smaller the part of the country's productive capacity which will be devoted to making plant and equipment. It is significant that during the period 1936 to 1939, which Mr. Nathan uses as a yardstick for profits, there was no net increase in the capital of industry.

Perhaps the country wishes the expansion and improvement of industry to be checked. Before reaching this decision, however, people should bear in mind that during most of the time since 1929 the creation of capital for civilian industry has gone on at an abnormally low rate. During much of this time the capital of the country's industry has been wearing out faster than it has been replaced. Today the country has far too little capital for a work force of 60 million, and much of the capital in use is obsolete by up-to-date technological standards. Mr. Nathan proposes substantially to discourage the most important process by which the country can raise its standard of living.

End of 1946 Debt Retirement Program

Treasury redemptions of $3,261 million 1½ per cent notes on December 16 marked the completion of a program begun March 1 of paying down the public debt by using the cash balances built up during the Victory Loan drive a year ago. These cash balances were held in War Loan account deposits with commercial banks throughout the country and their withdrawal brought about a nearly corresponding reduction in commercial bank holdings of government securities. The magnitude of these changes is shown as follows:

(In Billions of Dollars)

	Feb. 28, 1946	Dec. 18, 1946	Change
Total public debt..................	$279.2	$258.7	—20.5
War Loan account deposits	24.4	2.2	—22.2
Bank holdings of government securities	92.5*	72.8†	—19.7†

*Estimated by the Treasury Department. †Estimated by this Bank.

The 1946 debt retirement program removed a large block of potential spending power in the shape of the War Loan deposits, though there remains a very substantial war-time deposit expansion, which is of course an inflation threat.

The change in the general structure of the debt over the full period of the program is brought out in the following table:

Composition of U. S. Government Debt
(In Billions of Dollars)

	Feb. 28, 1946	Dec. 18, 1946	Change
Treasury bills	$ 17.0	$ 17.0	....
Certificates of indebtedness	41.4	30.0	—11.4
Treasury notes	19.6	10.1	— 9.5
Treasury bonds	121.6	119.3	— 2.3
Other bonds	0.2	0.2	....
Total :narketable obligations	199.8	176.6	—23.2
Savings notes	8.0	5.8	— 2.2
Savings bonds	48.7	49.7	+ 1.0
Depository bonds	0.5	0.3	— 0.2
Armed forces leave bonds..	....	0.5	+ 0.5
Special issues to government agencies and trust funds	20.9	24.3	+ 3.4
Total nonmarketable obligations	78.1	80.6	+ 2.5
Noninterest bearing debt	1.3	1.5	+ 0.2
Gross public debt	$279.2	$258.7	—20.5

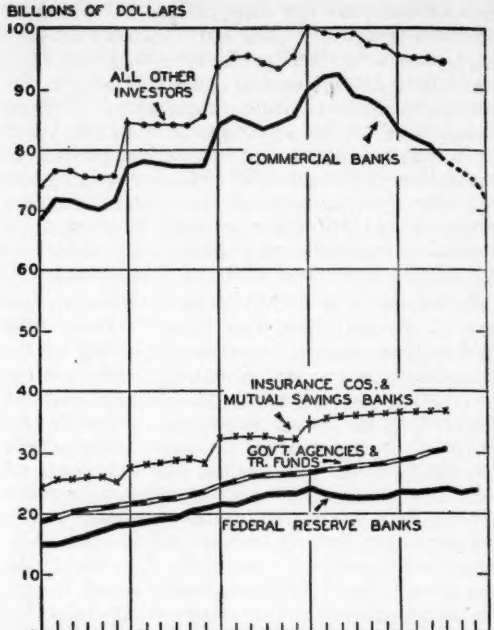
The big reduction took place in obligations of the type traded in the open market. About half of the monthly maturing Treasury certificates and notes were paid off, and new issues of one-year certificates were offered in exchange for the remainder. There was a $2.5 billion rise in nonmarketable debt over the February 28-December 18 period, as is brought out in the lower section of the table.

Effects of Program on the Money Market

As the accompanying chart suggests, commercial bank holdings of government securities bore the brunt of the debt redemptions. While the Treasury figures upon which the chart is based go only through September, the figures for commercial banks and Federal Reserve Banks have been projected with the weekly Federal Reserve statements as a guide.

Some other significant shifts of holdings over the period of debt retirement are also brought out in the chart — such as the continued increase, though at slackened pace, in holdings by insurance companies and mutual savings banks, and the downturn in holdings by "all other" investors. Postwar needs for funds as well as liquidation of speculative holdings were evidently more important than the debt retirement program in the drop in holdings by individuals, partnerships, corporations and associations included in the "all other" group.

Insurance companies and mutual savings banks were buyers of long-term securities re-



Holdings of U. S. Government Securities, Direct and Fully Guaranteed.

linquished by "all other" investors and shared with the Federal Reserve Banks in absorbing certificates and notes sold by commercial banks. Treasury bills were shifted in considerable amounts to the Federal Reserve, principally from the commercial banks.

Stiffening of Interest Rates

The drain on bank deposits and holdings of short term governments, and the repeated pressures of bank selling, led to some firming up in market rates of interest from the extremely low levels previously prevailing, and to a scaling down of the high premiums commanded by government bonds during the speculative surge of the late Winter and early Spring.

Typical open market rates were marked up ¼ to ½ per cent, as the following table shows, and yields on top grade securities showed increases in much the same general range. With bank holdings of Treasury bills sharply drawn down, the ⅜ per cent rate on these securities pretty much dropped out of the running as an important part of the interest rate structure and ⅞ per cent certificates became the effective basing point for other rates.

Debt retirement, of course, has not been by any means the sole influence in the stiffening of money rates. Business needs for funds have surpassed the expectations of many observers. The rise in the price level has sharply increased the cost of new plant and equipment

Representative Open Market Money Rates and Security Yields

	Feb. 28, 1946	Dec. 24, 1946
Prime commercial paper	5/8%	1%
Prime bankers' acceptances, 90 days	7/16	13/16
Stock exchange call money	1	1 1/2
Treasury bills	3/8	3/8
Treasury certificates of indebtedness, one month to maturity	.20	.74
1½% Treasury notes due Sept. 15, 1948	.82	1.01
2% Treasury bonds of December, 1952-54	1.24	1.48
Moody's Aaa corporate bonds	2.48	2.60
Standard & Poor's high-grade municipal bonds	1.49	1.99

and at the same time has enlarged needs for working capital. Interruptions to operations from strikes and other causes seem to have affected business needs for funds two ways — they have resulted in the deferment or cancellation of some plans for plant expansion and modernization and at the same time have drained away working capital to a point where it had to be replenished. The stock market break in September put a damper on new security flotations and lately there has been a noticeable shift from offerings of common stocks to preferreds, and from public offerings to credits negotiated with banks and insurance companies.

A revival of state and municipal new security offerings, stimulated by approval at the November election of bond issues to pay veterans' bonuses, a rise in the demand for real estate mortgage credits, and an expansion in consumer borrowings have joined with the growth in business loans to mop up new investment funds coming on the market, and to create attractive alternatives to the holding or purchase of government securities yielding lower rates of return.

Besides the debt retirement program, a number of official measures were adopted working in the direction of a limited firming of money rates. The Federal Reserve Banks increased the rate charged on member bank borrowings secured by short-term governments from ½ to 1 per cent, and the New York Reserve Bank also raised its minimum buying rate for bankers' acceptances from ½ to 1 per cent. From June through November $520 million government bonds were put on the market from government investment accounts.

Question-marks of 1947

With the end of the 1946 debt retirement program, questions are being asked as to what lies ahead:

Will business, consumer, state and municipal demands for credit continue their expansion? The most common expectation seems to be that they will.

How much of the $54 billion marketable debt coming due in 1947 will the Treasury be able to pay off out of surplus revenues plus accruals of social security funds? Even under the most favorable circumstances this year's debt retirement will be only a fraction of that in 1946.

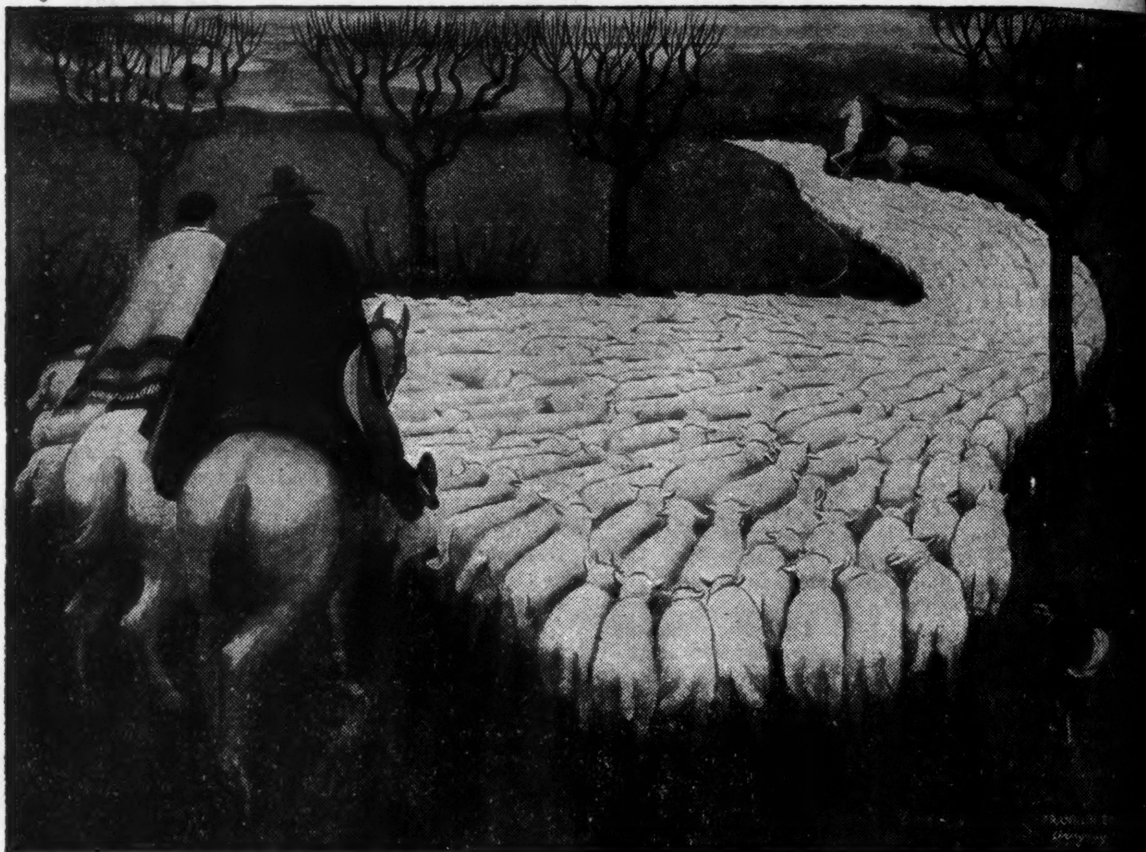
Will the Treasury offer long-term bonds for cash subscription by nonbank investors to help cut down floating debt and mop up some investment money hunting around for places to go? The answer here is likely to hinge on the behavior of the government security market and the amount of free funds in evidence.

Will the authorities feel the necessity of reconsidering the wartime pattern of rates and the Federal Reserve commitment to hold to the pattern at all costs? The decision on this point will be influenced by the course of business, credit, and prices in 1947 as well as by Congressional reactions to the Federal Reserve request for powers directly to regulate bank holdings of government securities.

Allan Sproul, President of the Federal Reserve Bank of New York, provided some stimulating food for thought along this line in a speech before the New Jersey State Bankers Association, December 6. Advocating a "modest approach to restoring credit control," he stresses the importance of "breaking out of the straight jacket of the pattern of rates," of "defrosting" the "presently frozen short-term rates on government securities," of "restoring some flexibility to the interest rate structure."

Mr. Sproul does not feel that restoration of flexibility in the rates on short-term governments is "an urgent matter of the moment." Other actions and factors, such as the debt redemptions, have given time to consider the problem. Nor does he believe that it is necessary to do anything "spectacular" or "drastic."

But he is firmly of the view that the Federal Reserve System must regain a position in which it will "be able to apply the brakes to credit expansion when inflation threatens, even if we can apply them ever so gently." The very size of the public debt and of the bank holdings of the public debt, he points out, have made the money market much more sensitive to relatively modest action than was formerly the case.



Painting by Franklin Boggs—"To Market"

Sheep Finance Uruguay's U.S. Imports

MILLING herds of some 20,000,000 sheep and 8,000,000 cattle comprise the backbone of Uruguay's economy. About the size of South Dakota, Uruguay consists for the most part of rolling, rich grasslands. It is an ideal pastoral country, and livestock-raising is by far the most important occupation. Attention is now being paid more to development of improved types than to increase in number of livestock.

Dairying has become a significant part of Uruguay's agricultural program. During the war the country became self-sufficient in certain dairy products and in breadstuffs.

Uruguayan exports to us expanded about sixfold during the war. In 1945 they reached $56,000,000, which was nearly 50 per cent of the total Uruguayan exports in that year. In 1945 we supplied Uruguay with almost $30,000,000 of machinery and other goods, or about 32 per cent of total imports, and in 1946 they reached a still higher total, probably above $40,000,000.

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